Change the focus

Large Corporate OMB



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Tom Haberfield and *Martin Hook* consider how the UK R&D tax regime can be improved

Key Points

What is the issue?

The Research & Development (R&D) Tax Relief regime was first introduced in the UK in 2000 as a way of encouraging businesses to engage in scientific and technological

innovation. The objective of this support, for the most part, was to entice companies to undertake R&D activities that might not have otherwise been conducted and as such, was an extremely important step for industry and economic progression..

What does it mean to me?

However, many common costs, most often directly related and pivotal in the delivery of R&D activities, fall outside these categories and so are unfortunately excluded from being claimed. So, if common and obviously important, have these costs been omitted intentionally or just overlooked by the regime?

What can I take away?

So is R&D tax support in the UK therefore currently missing the mark? If so, how could HMRC make changes to ensure that the Regime is delivering what it needs to.

The Research & Development (R&D) Tax Relief regime was first introduced in the UK in 2000 as a way of encouraging businesses to engage in scientific and technological innovation. Following suit of other jurisdictions such as Australia, Canada and France, the UK looked to incentivise companies investing in R&D by allowing additional tax deductions on eligible R&D expenditure. The objective of this support, for the most part, was to entice companies to undertake R&D activities that might not have otherwise been conducted and as such, was an extremely important step for industry and economic progression. R&D activities not initially feasible for a company to undertake might suddenly become possible, with the outcomes not just benefiting the company and its industry, but also the wider economy.

With the objective in mind, it could be reasonable to assume, therefore, that the regime’s potential ‘net’ might act more like a bucket, providing support for all the reasonable costs incurred – whether direct or indirect – in physically undertaking an R&D project. It would be this level of support which would make companies stand up and take notice, signifying a regime which truly understands the R&D process and most importantly, the true costs involved in undertaking it. The current R&D regime in the UK provides up to seven eligible expenditure categories for making a claim, such as staff, consumables and software. However, many common costs, most often directly related and pivotal in the delivery of R&D activities, fall outside these categories and so are unfortunately excluded from being claimed.

Take Subcontractors and Externally Provided Workers (EPW) for example. These are two cost categories within the R&D Tax legislation that are defined in legislation (Corporation Tax Act 2009 s1078 and s1128 respectively) and which represent two specific but different scenarios within an R&D process. The first represents the completion of a task, clearly defined at the outset and which is undertaken by either an individual or a company, whereas the second involves the provision of services, again by an individual but only if that individual has been supplied by a staff provider or staff controller.

So what happens if you have an individual, such a sole trader, who provides R&D services?

Well, in our experience this can be quite common, where we see individual sole traders being commissioned by our clients to undertake internal R&D services. These individuals, who work under the supervision, direction and control of our client, are inherently regarded as EPWs until it is assessed how they have been supplied. Being sole traders, individuals fail the 'staff provider' test (the requirement that there be a separate entity, the 'staff provider', between R&D claimant and the individual worker) and as such, do not meet a fundamental requirement of an EPW. Not a huge problem, one might think, as a 'catch-all bucket' mentality would expect such personnel – essential to our client's R&D process – to surely be captured within the regime in some way; but they are not. As it stands, when you take into account the nature of the obligation these sole traders have to the claimant, i.e. internal service providers, you find they also happen to fail the basic definition of 'subcontracted R&D activities'. Although seemingly counterintuitive, failure to satisfy either of these two definitions can only lead to one result: that the costs are excluded from the claim entirely.

A specific example of this occurred recently with one of Ayming's prominent construction clients. In this example, the client had directly contracted an outside, sole trading specialist to coordinate a specific R&D project in conjunction with its own internal staff. Upon preparing the claim, however, it was determined that although pivotal to the R&D project and clearly a direct R&D cost, this particular individual working under the supervision, direction and control of the client failed to be classified as an EPW as his contract arrangement did not include the provision of staff provider/controller. Although seemingly counterintuitive to the R&D scheme's purpose, this omission, in conjunction with the obvious inability to include him under

any other cost category, meant that a core contributor of the eligible R&D project had to be excluded from the claim.

But how could this be?

One might point to the employment mentality at the time the legislation was first drafted. Back in the late 1990's, self-employment was an unappealing proposition, with job security and paid entitlements being seen as the far more attractive employment option. Fast forward this a decade or two and it is clear the priorities within society are changing, with short term autonomy, the rise of the 'gig economy' and potentially higher wages for individuals beginning to outweigh any desire for long term stability. This shift in priorities has not just confined itself just to the individual either, with businesses now capitalising on self-employment as a strategy to reduce costs. The introduction of 'zero-hour' and freelance contracts has given companies the ability to dynamically respond to issues of periodic scalability and short-term labour intensive projects, all whilst removing the general obligation to pay employee entitlements.

Whatever the reason for this unfortunate technicality, however, it is clearly working against the intention of the regime and so I ask: what other essential expenses are commonly incurred by companies during an R&D process, which are then unfortunately excluded from the R&D Tax regime?

The areas which commonly cause confusion amongst our clients are the hiring of plant & machinery or overheads such as rent. Under the UK R&D tax regime, any costs relating to the rental of premises or technical equipment is passively (not explicitly) excluded from the regime; due only to the fact that the legislation fails to provide an attributable expenditure category. Renting of workspace or hiring of equipment is often a direct cost, commonly incurred by our clients as an essential cost in the process of R&D. The basic premise of undertaking highly innovative and advancing activities will almost certainly require the use of specialist equipment and/or additional/designated floor space; most often unavailable or unfeasible to purchase for the finite duration of an R&D project. This situation is very common for construction and manufacturing clients who often require extra space or specialised equipment to undertake their larger and more complex projects. A recent example of this occurred with one of Ayming automotive clients who needed to rent additional warehouse space to develop and trial a new paint line for their business. Clearly, the development and trialling of the new line could not have been

undertaken without the designated space but, as mentioned earlier, the additional rental cost associated to this R&D project could not be included in their claim.

So, if common and obviously important, have these costs been omitted intentionally or just overlooked by the regime?

Similar to the priority shift in employment, it is worth discussing the evolving willingness of companies to burden themselves with the often large and ongoing cost of acquiring highly specialised pieces of equipment. Although it was once common for companies to invest in specialised capability, it is obvious that outsourcing has become far more attractive to today's business model, especially in industries with highly technical applications such as construction, IT and biotechnology. As we are now seeing, subcontracting of labour to undertake specialised or one-off tasks is common practice across highly technical industries, but what we seem to forget is that these services will also most certainly require the use of specialised equipment. Although the UK R&D scheme allows for this subcontracted labour cost to be included in certain R&D claims, it fails to recognise the cost of the equipment integral to providing these services. This is an interesting position to take as it seems obvious that when subcontracting an activity (whether R&D or otherwise) you are paying for an outcome, however that may be achieved.

Looking at other R&D Tax regimes around the world, it is clear the UK has fallen short in its support of what is required to undertake R&D projects; assuming its intention was to provide a genuine incentive for companies to invest in innovation in the first place. Australia, for example, allows nine broad categories of eligible expenditure, providing holistic support through a clear appreciation for the breadth of both direct and indirect costs required in undertaking R&D.

How does it do this?

Australia has included in its regime an eligible expenditure category described as 'Other'. Reserved for reasonable costs which fail to align with the more specific expenditure categories, 'Other' tends to include proportions of expenses such as plant hire, rent, technical training and even subscriptions. Although not the focus of the R&D itself, these costs are often necessary to develop, build, prepare, transport, test or analyse an R&D project and as it currently stands, would all be excluded under the UK R&D regime.

Just to be clear, this is not questioning the generosity of the UK R&D regime, this is merely highlighting its focus. The generosity of the UK's R&D regime allows companies to access numerous opportunities for support. These can include claiming 'overseas' expenditure without the need for preapproval (provided it is incurred and overseen by the UK claimant), or tapping into the Capital Allowance tax provisions so that a proportion of assets can be written off in the year they are capitalised (if they were used for R&D purposes). The point though is that these upsides are only really applicable to a small proportion of claiming companies, whereas the more common direct and indirect expenditure we find in most R&D projects remains unsupported.

So is R&D tax support in the UK therefore currently missing the mark?

I think yes, and believe HMRC should re-focus its UK R&D regime accordingly.

The immediate path for HMRC should be consultation with industry and advisors to gain a better understanding of what 'other' costs are commonly incurred during R&D projects and in addition, to recognise the more obscure but increasingly common third-party arrangements which currently lead to exclusion. Only through consultation will HMRC gain the necessary insight and understanding into the current areas of support being irrationally overlooked and begin working to close this gap.

Holistic support is the first step in focusing the UK regime and its subsequent ability to incentivise R&D. It is true some of the current outlying 'generosities' may need rethinking, but the end result will be a regime that truly understands what it is incentivising and so will direct support exactly where it is needed.